Making the Case for Value

Disruptive Forces in Investing

January 12, 2021

Anu Rajakumar: As many seasoned investors may know, there are two main schools of thought when it comes to investing in stocks. Growth and value. While growth has been the more popular option in recent years, moving in 2021 investors are increasingly considering a rotation to value. What is it about value that could be attractive to seasoned and new investors alike? My name is Anu Rajakumar. And today on *Disruptive Forces,* I'm joined by Eli Salzmann and David Levine, portfolio managers for large cap value strategies here at Neuberger Berman, who will share more about the world of value investing. Eli and David, thank you for joining me today.

Eli Salzmann: Thank you for having us.

David Levine: Great to be here. Thank you.

Anu: So just to set the groundwork for our listeners, Eli, maybe starting with you, could you share some of the main characteristics that make value investing attractive to investors and then maybe contrast it to growth investing?

Eli: Sure. You know, the market typically has three main cycles. The first cycle is value, the second cycle is growth, and the third cycle is really what I call stability. Value tends to outperform in periods of economic acceleration. And growth tends to outperform when you enter periods of economic deceleration. And let me explain. In a value environment, the reason value out-performs is because you can buy that economic acceleration in cheaper stocks. And all companies benefit, but value stocks are a whole lot cheaper and they get the – the benefit of that economy, um, acceleration. Whereas in a decelerating environment, that's when people – it's a little counter-intuitive, but people pay a premium for growth when growth really isn't there. And that's when you do want to be on the growth side. You know, David and I believe that, you know that we're at a period now where the economy is accelerating and will do so for a number of years. Um, and with that acceleration, um, we will also get inflation. And with that inflation we will get higher interest rates. So, we believe as we look back at past cycles, as we look at the characteristics of what's going on right now, um, you do want to be in value over growth.

David: I think another interesting point to raise for, for investors out there is, over the past 13 years we've been in a cycle where growth has out-performed value. And it's really important to think about the diversification that you have in your portfolios, and that's where really value comes into play at this, at this moment in time. Most investors are overweight core in growth investments. Most value investors have even left the fold of being true value investors, even to the extent that four out of the five top net flow gatherers in the value world last year owned one of the FANG stocks in their top five holdings. It's really important to think about where you're invested in value and are, they a true value manager.

Anu: Yeah, I think that's an important point for investors to consider about their over-exposure, over-concentration to certain stocks which may not align with typical value investing. I want to dive a little bit into some sectors where you've seen value opportunities. Now you mentioned some of the types of companies that we find in value, but Eli and David, you've both been in this business for around 30 years. Where in particular have you seen the opportunities emerge given the current environment? And maybe just to follow up on that, what are some of the key indicators that this is a good environment for value?

Eli: Sure, sure. So, the sector where we're finding value right now, it's really four main sectors: financials, energy, industrials and basic materials; and then specifically within basic materials, it's really places like copper and gold. Copper is something that we've loved for a little while here and we continue to love. In the case of financials, it's really the asset sensitive financials which would really be the banks and the life insurance companies, companies that do benefit from a rising rate environment. And then within energy it really comes down to the amount of capacity that has come out in energy has made energy awfully attractive. So, the combination of all those factors, those are the sectors that we are finding an incredible amount of value. The areas where we're not finding value, and this is probably no surprise in light of our previous answer about value vs. growth, are places like technology and consumer discretionary.

David: And just to drill down on one of the points Eli was making, when we think about industries that are attractive, one of the main elements of our focus is finding industries that have been starved of capital and therefore capacity, and it makes it easier for the companies that are involved in, in those industries to earn better margins going forward. And so if you think about, just from a competitive perspective, how many people are in certain industries vs. other industries, take for example the market cap of Apple, or the market cap of Amazon, or the market cap of Microsoft. Each one of those companies individually has a bigger market cap than the entire energy space in the United States. Right? So just think about, from a capital capacity perspective, where the capital flows are going and where they're not. And that's usually the opportunity for a value investor.

Anu: You know, you both mentioned energy, and I wanted to ask you if we can just dig in a little bit deeper on energy specifically given, you know, a lot of pessimism around energy as a long term investment. Would you mind – Eli, maybe just talking a little bit further about energy?

Eli: Sure. So, you know, energy has obviously had a very rough period here for, um, call it just shy of a decade. Starting in 2014, energy suffered from magnet little bit too much in the way of supply and you've seen an awful lot of capacity come out. David talked about, you know, one of the things, one of the reasons we find certain sectors like energy attractive is because capital has, you know, capital and capacity have come out of those sectors and energy is sort of the poster child for that. So, if you look at energy six or seven years ago, you're dealing with a sector that had about 900 active rigs. Today you're dealing with a sector that has about 200 active rigs. So that kind of capacity takeout is massively bullish. When we have that kind of supply takeout, for any industry, and energy happens to be that industry right now, that's, that is very, very positive for the sector, assuming we get demand recovery. We do believe that with this economic return that we're going to get, um, you know, coming up, the combination of the demand factor going up and the supply coming out, uh, we are very bullish on energy and very bullish on the price of oil.

Anu: Great, thank you. Very helpful. Um, now some people have questioned the validity – sorry. Now some people have questioned the validity of the value vs. growth paradigm in this challenging environment with the coronavirus. Um, do you believe that it still exists, or have we indeed shifted to a new framework that some are calling “quarantine vs. recovery”?

Eli: You know, the way I would answer that is this. This has been the perfect storm by all means for growth over value in the sense that, you know, in this, in this pandemic we've had to work from home, socialize from home, shop at home, and that is one of the reasons many of these growth stocks, um, you know, from the Apples to the Googles to the Amazons, companies that David just referred to, have done as well as they have. But if and when the world does come back to normal, and it will happen, um, people – I'm not saying that people aren't going to feel a little more comfortable shopping, um, at home and – and you know, using the technology tools that, that have been there and have some of that been, you know, um, put, you know, forward in time – the answer is yes. But people also still like to do, um, things that they used to do before the pandemic. And we believe that many of those, um, value opportunities exist and, um, we believe that, you know, when we do return to normal, it's not going to be quite as one-sided as it's been for the last eight months.

Anu: Yeah, I think we're all, we're all looking forward to that time and hoping it comes sooner rather than later. Now just as we wrap up here, would love to get some final thoughts about why you think now more than ever is the opportune for value investing both for new investors as well as seasoned investors.

Eli: You know, it's been 13 years where growth has obviously beaten value and there is an amazing amount of money that has gravitated into portfolios that have an awful lot of growth in them. So if you look very carefully at your own portfolios, you'll see that not only do you own growth portfolios which are something that you, you know, was done by design, but even things like the core benchmark, um, which is called the S&P, the S&P is really no longer core-like. It's really somewhat growth-like. And then taking it one step further, there are an awful lot of value portfolios out there that call themselves value but have, um, bought an awful lot of these growth stocks and they're not really quite value anymore. So, the amount of money that has entered the growth arena and literally abandoned value has created valuation discrepancies that we haven't seen in 20 years. So, if you look at where value is today and where growth is today on a long-term valuation basis, the spread is as big as it's ever been, including the '99/2000 bubble. So the opportunity, if we're right about the environment, that we believe, possibly will take place over the next three to five years, the chance to win and win in a sizable way in terms of performance of value over growth, we think that, that possibility is there in, you know, in a big way.

David: And in terms of some of the catalysts that Eli and I believe are playing out as we sit here today, to, to generate that closing of the gap, we think about the to-, the amount of monetary and physical stimulus that's been poured into the system. We think about the additional physical stimulus and monetary stimulus that's potentially coming and being talked about right now. We think about how interest rates and inflation expectations are slowing going up. And those are all beneficiaries, historically have been beneficiaries, to the more value-related sectors. So, if you think about financials, which Eli talked about earlier, right? A steeper yield curve is something that is very beneficial from an operating perspective for those companies, in terms of their ability to generate earnings and cash flows. If you think about, from an inflation perspective, the materials, the industrials, the energy space, you know, as those inflation expectations turn into actual inflation, those will benefit those sectors as well. And so we think we're lined up, both from the perspective of where we've been, from the spread that exists between growth and value, as well as the catalysts that seem to be presenting themselves, in the marketplace for those value sectors to now potentially have a comeback in performance.

Eli: You know, one of the things that's, that's very important to understand is that, you know, the reason we are, um, the reason we're predicting inflation here, and this is really the first time in, you know, call it 30-plus years that we've had any real inflation. It's not just the fiscal and the monetary stimulus that's been at unbelievable record levels, but it's also, um, the de-globalization that's taking place, um, for the first time in a long time. You know, one of the things that's very important to understand is that in the late '90s, um, the world opened up and we went through a globalization period where we imported a lot of excess capacity from places like Eastern Europe, places like China, places like India. And that really kept our inflation down, and it created this wonderful disinflationary environment. That globalization in free trade is now taking several steps back and if you think that globalization is what kept inflation down, which is what we believe, not that technology didn't play a role; but globalization played a much bigger role. This de-globalization, this several steps back, and this, you know, opposite of free trade, which is protectionism, will bring about inflation. And inflation brings about higher interest rates and higher interest rates, history has shown us, is usually good for value.

Anu: Great, that's terrific. I think very helpful to relate the, the opportunity set here to your macro view, and also what you said about the role of globalization here as well. So, I just want to thank you both for joining me today to discuss this important topic of value investing. Certainly looking forward to seeing what is indeed in store for value investors in 2021 and beyond.

Eli: Alright, thank you so much for having us.

David: Great questions. Thank you for having us, Anu.

Anu: And to our listeners, if you've enjoyed this episode of *Disruptive Forces*, I encourage you to subscribe to the show via Apple Podcast, Google Podcast, or Spotify. Or you can visit our website, www.nb.com/disruptive forces, for previous episodes, as well as more information about our firm and offerings.